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Check Your Bequests - Deemed Resident Trust Rules May Apply

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The breadth of the rules in section 94 of the Income Tax Act (Canada) (the "Act"), which may apply to deem what would otherwise be a non-resident trust to be a Canadian resident trust (and, thereby, taxable on its worldwide income), was illustrated in a recent Canada Revenue Agency ("CRA") technical interpretation.

Generally speaking, pursuant to subsection 94(3) of the Act, an otherwise non-resident trust will be deemed to be a Canadian resident trust for the purposes of the application of most provisions of the Act if "…at a specified time in a trust's particular taxation year…the trust is non-resident…and, at that time, there is a resident contributor to the trust or a resident beneficiary under the trust."

In CRA Document No.: 2013-0514771E5 (the "Interpretation"),[1] the CRA was asked whether a Canadian resident's unconditional bequest in his will to a non-resident trust (the "Trust")[2] would, by virtue of section 94, result in the Trust being deemed to be resident in Canada. That is, acknowledging that there was no Canadian "resident beneficiary" of the Trust, could the decedent or his estate be considered to be a "resident contributor" for the purposes of section 94 such that the Trust would be deemed to be resident in Canada under the Act. The CRA's answer in the Interpretation was yes.

The CRA agreed that, given his death, the decedent was clearly not in existence and, as such, could not be a resident of Canada. As such, the decedent could not be a "resident contributor" to the Trust for the purposes of section 94 of the Act.

However, the CRA concluded that the Trust would have a "resident contributor" and would, therefore, be deemed to be resident in Canada for the following reasons:

a) an estate (i.e., the decedent's estate, referred to hereafter as the "Estate") is a trust, pursuant to the definition of "trust" in subsection 248(1) and subsection 94(1) of the Act;

b) under section 94, a "contributor" to a trust means a person, other than an exempt person but including a person that has ceased to exist, that at or before that time has made a "contribution," for the purposes of subsections 94(1) and 94(2) of the Act to the trust;

[1] June 26, 2014
[2] The Trust was previously settled outside of Canada by a non-resident of Canada, the trustee of the trust was a non-resident of Canada and the sole beneficiary of the Trust was a non-resident (the child of the decedent). Central management and control of the Trust was also exercised outside of Canada such that, at common law, the trust was not resident in Canada.

c) pursuant to paragraph (a) of the definition of "contribution" in subsection 94(1) of the Act, a "contribution" to a trust by a particular person includes a transfer or loan (other than an arm's length transfer) of property to the trust by the particular person;

d) pursuant to paragraph 94(2)(g) of the Act, when the Trust acquired its interest in the Estate, the Estate would be deemed to have transferred the interest to the Trust. As such, the Estate would be considered to be a contributor to the Trust, for the purposes of subsection 94(1) of the Act. Assuming that the decedent's estate was a resident of Canada, the result would be that the Estate would be a "resident contributor" to the Trust, with the result that the Trust would be deemed to be resident in Canada, pursuant to subsection 94(3) of the Act, throughout the relevant taxation year; and

e) under paragraph 94(2)(n) of the Act, a contribution made at any time by a particular trust to another trust is deemed to have been made at that time jointly by the particular trust and by each person that is at that time a contributor to the particular trust. As such, per the Interpretation, the decedent would also be considered to be a "contributor" to the Trust, as defined in subsection 94(1) of the Act. Presumably, this conclusion would be relevant to the determination of whether or not, with respect to a particular non-resident trust under consideration, there is a "resident beneficiary," since this definition necessitates there being a "connected contributor," which, in turn, requires that there be a "contributor" to the trust at issue. In the Interpretation, given that there was no "resident beneficiary", the determination by the CRA that the decedent was considered to be a "contributor," for the purposes of subsection 94(1), was not relevant to its conclusion that the Trust was deemed to be a Canadian resident trust.

With respect, the CRA's rationale in the Interpretation concerning the application of paragraph 94(2)(g) is questionable. In the Interpretation, the CRA states:

Pursuant to paragraph 94(2)(g) of the Act, when the Trust acquires its interest in the Estate, the Estate will be deemed to have transferred the interest to the Trust. Accordingly, the Estate will be considered to be a contributor to the Trust. [emphasis added]

The October 24, 2012 Technical Notes (the "Technical Notes") regarding paragraph 94(2)(g) of the Act state:

For greater certainty, paragraph 94(2)(g) provides that a corporation is considered to transfer shares that it issues. Similar rules, also contained in paragraph 94(2)(g), apply to interests in a trust acquired otherwise than from a beneficiary under the trust and interests in a partnership acquired otherwise than from a member of the partnership, as well as to debt issued to a person or partnership by another person or partnership and a right (granted after June 22, 2000 by the person or partnership from which the right was acquired) to acquire or to be loaned property.

In this Interpretation, the CRA appears to be relying on subparagraph 94(2)(g)(ii) of the Act. That is, the acquisition by the Trust (i.e., the "particular person" in paragraph 94(2)(g)) of an interest as a beneficiary under a trust (i.e., the Estate) from the Estate is deemed to be a transfer of property by the Estate at the time that the Trust acquired an interest in the Estate. However, based on the Technical Notes, it is apparent that paragraph 94(2)(g) is not intended to apply in circumstances such as those addressed in the Interpretation.

More specifically, the Trust is not acquiring an interest as a beneficiary in the Estate from the Estate or the decedent. Nor is the decedent's child acquiring an interest in the Trust from the Estate or the decedent. Put simply, no interest as a beneficiary under the Trust is being transferred by the Estate or the decedent. As such, paragraph 94(2)(g) cannot apply in the circumstances stated in the Interpretation. The decedent is merely making an unconditional bequest of property to an existing non-resident trust of which the decedent's non-resident child is already a beneficiary. As such, contrary to the CRA's conclusion, there is no deemed transfer of property by the Estate, pursuant to paragraph 94(2)(g) of the Act.

This point is, however, academic because the Estate is, in fact, transferring the bequeathed property to the Trust. This would constitute a "contribution" and the Estate would be a "contributor," pursuant to the definitions of those terms in subsection 94(1) of the Act. Assuming the Estate is resident in Canada, it would constitute a "resident contributor," with the result that subsection 94(3) of the Act would apply to deem the Trust to be resident in Canada in the relevant taxation year and for years thereafter until the "resident contributor" (i.e., the Estate) is wound-up. The Executors of the Estate and the trustee of the Trust would, therefore, wish for the Estate to be wound-up as soon as possible to eliminate the "resident contributor" to the Trust and the application of section 94 of the Act to the Trust.

The implications of this Interpretation are troublesome.

Consider that the Trust at issue in this interpretation had absolutely no connection with Canada. Further, had the decedent made the bequest in his will directly to his non-resident child (as opposed to the Trust of which the child was the sole beneficiary), the Trust would not be deemed to be resident in Canada under the Act (and would not, thereby, be liable to Canadian income tax on its worldwide income in the relevant taxation year). Alternatively, the decedent could have, prior to his death, simply gifted the cash or property which was the subject of the bequest to the non-resident child.[3] Yet, simply because the Canadian decedent (who, as the interpretation points out, was no

[3] Subsection 69(1) would likely apply in such circumstances to deem the decedent, prior to his death, to have received proceeds of disposition equal to the fair market value of the bequest. To the extent that the bequest was of cash, no Canadian income tax implications would have arisen for the decedent. To the extent that the bequest was of property, depending upon the fair market value of the property, the decedent would have realized a capital gain in respect of the disposition of the property, 50% of which would have been included in his income and subject to Canadian income tax. However, the amount of such gain and Canadian income tax (if any) is unclear based on the facts provided in the Interpretation. In addition, the amount of such gain and Canadian income tax (if any) would need to be considered in relation to the tax eligible on the Trust for the taxation year(s) in which the Trust is (and would be) deemed to be a Canadian trust (i.e., until the Estate is wound-up and there is no longer, using the CRA's analysis in the Interpretation, a "resident contributor" to the Trust).

longer in existence), made the unconditional bequest to the Trust, the CRA's analysis deemed the Trust to be a resident of Canada, with all of the requisite Canadian income tax filings and liabilities which accompany such residency status. Thus, as stated above, there would be significant pressure on the Executors of the Estate to administer and wind-up the Estate to remove the Trust from the Canadian tax net.

One might hope that, given the draconian consequences associated with the application of section 94 to otherwise non-resident trusts in circumstances similar to those addressed in the Interpretation (e.g., *bona fide* non-resident trusts which were not established with the goal of avoiding Canadian tax but which have one, isolated, very thin connection to Canada), the CRA might offer some form of administrative concession from the application of the deemed residency rules for trusts. However, practitioners ought not be optimistic about the provision of such a concession. As such, recognizing that members of families are frequently spread over many countries, this Interpretation must be carefully considered by practitioners in tax and estate planning and in drafting wills.

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